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ABSTRACT

Noting that a key challenge for policymakers and others who are concerned about the well-being of children and families is how to develop and improve policies that reward work and help low-income working families increase their earnings, this research brief examines the current and potential impact of state earned income credits (EICs) as a means of building on the positive effects of the federal EIC at the state level. The brief examines the role that state EIC programs have played in the level of children's economic well-being in the District of Columbia and the 15 states that had such programs in 2000 and analyzes how many children would be raised out of poverty if state EIC programs existed universally. The brief finds that the extent to which a state EIC benefits working poor families is critically dependent upon the size of the credit in terms of its percentage of the federal EIC and whether the credit is refundable or nonrefundable. Some state EIC programs have had substantial impact on the incomes of working poor families. The brief notes that with a 25 percent universal state EIC, over 500,000 children would escape poverty. Nonrefundable credit would benefit very few children compared to a refundable credit. Potential funding mechanisms are suggested, most notably the Temporary Assistance to Needy Families block grants. The brief concludes by noting that state EICs hold considerable promise to improve the lives of working poor parents and their children. (Contains 18 endnotes.) (KB)

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Untapped Potential: State Earned Income Credits and Child Poverty Reduction

Childhood Poverty Research Brief 3

Neil G. Bennett
Hsien-Hen Lu

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Childhood Poverty

RESEARCH BRIEF 3

Untapped Potential: State Earned Income Credits and Child Poverty Reduction

NCCP is publishing this research brief at a time when a large and growing share of children in poverty have working parents. A strong national economy and welfare reform have contributed to a significant increase in the proportion of poor families with at least one parent in the workforce over the past several years. In this context, a key challenge for policymakers and others who are concerned about the well-being of children and families is how to develop and improve policies that reward work and help low-income working families to increase their earnings. One of the most promising policies in this regard is the earned income credit (EIC). (Note: The EIC is also commonly referred to as the EITC or earned income tax credit.) Research by NCCP has documented the powerful anti-poverty effects of the federal EIC,[1] which benefits nearly 20 million working families each year. The federal EIC increases the after-tax income of these families by an average of about $1,500 per family at a total cost of just over $30 billion.[2] This research brief examines the current and potential impact of state EICs as a means of building on the positive effects of the federal EIC at the state level.

This is the third research brief in a series published by the National Center for Children in Poverty focusing on poverty dynamics in the 50 states and the District of Columbia. (Visit www.nccp.org for information on the first two research briefs in this series.)

There are two major objectives to this research brief:

- To examine the role that state EIC programs have played in the level of children's economic well-being in the District of Columbia and the 15 states that had such programs in tax year 2000.
- To analyze how many children would be raised out of poverty if state EIC programs universally existed.[3]

The major lesson to be drawn from this research brief is that the extent to which a state EIC benefits working poor families is critically dependent upon two factors:

- The size of the credit in terms of its percentage of the federal EIC, and
- Whether the credit is refundable or nonrefundable (the latter being of virtually no value to working poor families, regardless of the percentage of the federal EIC at which it is pegged).

Further, it is clear that some state EIC programs have had substantial impact on the incomes of working poor families. Such programs must be expanded in two ways—improved in their generosity and extended to additional states—for their benefits to be felt even more significantly at the national level. The potential impact of state EICs should also be considered in light of recent evaluations of the New Hope program[4] and the Minnesota Family Investment Project.[5] This research suggests that when states provide the right type of fiscal incentives to parents for low-wage work, not only do welfare rolls fall, but family incomes rise, poverty rates fall, and young children's academic achievement and social-behavioral development improve.

The Impact of State Earned Income Credits on Child Poverty

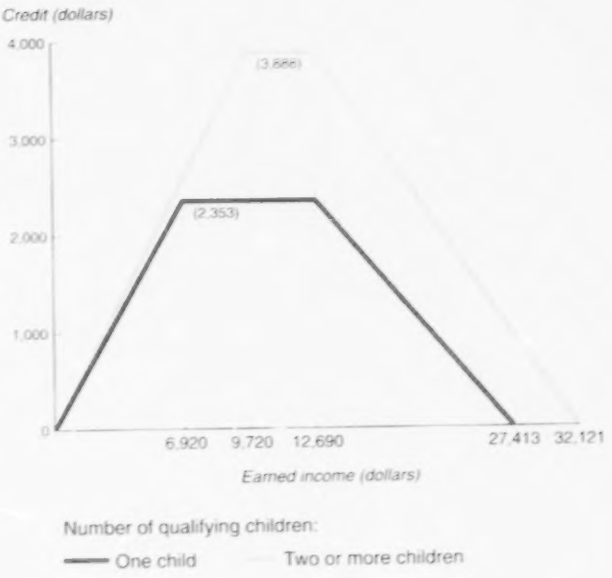
The federal Earned Income Credit was created in 1975 to offset the burden of Social Security and Medicare payroll taxes on working poor families and to improve family economic well-being. It has enjoyed bipartisan support, as increases in the credit have been signed into law by Presidents Reagan, Bush, and Clinton. Its effect has been sizable, especially since its most recent expansion in 1993.[6]

The Federal EIC

For tax year 2000, the maximum credit for the federal EIC was $2,353 for families with one child and $3,888 for families with two or more children. In 2001, the EIC is set to rise to $2,424 for families with one child and $4,008 for families with two or more children. Working families with no children received a maximum credit of $353 in tax year 2000, which will rise to $364 in 2001. The income/credit structure in 2000, diagrammed in Figure 1, was as follows:

> Families with two or more children receive an [EIC] equal to 40 cents for each dollar up to $9,720 earned in 2000. Families with one child receive an [EIC] equal to 34 cents for each dollar earned up to $6,920 of earnings. Both types of families continue to be eligible for the maximum credit until income reaches $12,690. For families with incomes above $12,690, the [EIC] phases out as earnings rise. Families with two or more children are eligible for some [EIC] benefit until income exceeds $31,152, while families with one child remain eligible for some [EIC] benefit until income exceeds $27,413.[7]

Figure 1: Benefit structure of the federal EIC, tax year 2000



Indeed, approximately 2.5 million children are lifted out of poverty due solely to the federal EIC program.

Not only has the federal EIC program raised the income of working poor families, but it also has established incentives that increase the labor force participation of single mothers.[8] These incentives have helped to reduce the welfare rolls.[9]

Witnessing the success of the federal EIC, a growing number of states have established or expanded EICs in the past few years. In 2000, state EICs existed in the District of Columbia and 15 states, the purpose of which were to provide relief from state and local taxes paid by low-income working families. The 15 states were Colorado, Indiana,[10] Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Vermont, Wisconsin, Illinois, Iowa, Maine, Oregon, and Rhode Island. Typically, these credits piggyback on the federal EIC.

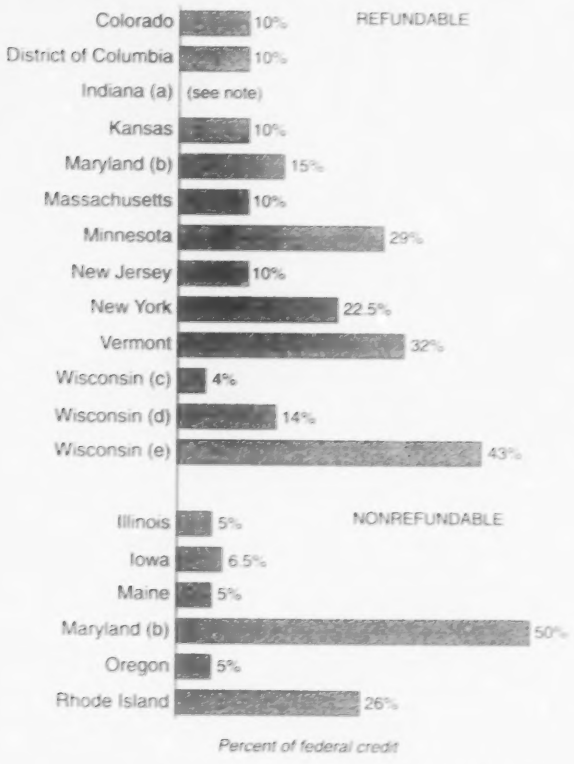
The state EICs were refundable in the District of Columbia and the first ten states listed above—meaning that the individual received the full amount of the credit even if that amount exceeded his or her state income tax liability. In the remaining five states, the EIC was nonrefundable—meaning that the individual received the full credit only if the state income tax liability equaled or exceeded the credit amount; otherwise, the taxpayer received only that part of the credit that reduced his or her state income tax liability to zero.

Figure 2 shows that maximum available state credits ranged from 5 percent of the federal EIC in Illinois, Maine, and Oregon to 50 percent in Maryland. In 2000, Maryland was phasing in its refundable EIC and phasing out its nonrefundable EIC. The state allowed individuals to claim the larger of either the refundable state EIC at 15 percent of the federal EIC or the nonrefundable credit, pegged at 50 percent of the federal credit.

The findings in the following analyses are based on the state EIC programs that existed for tax year 2000, which are, in turn, applied to a three-year average of population and annual income data for 1997 through 1999 gathered from the three most recent available Current Population Surveys (CPS) (conducted in March of 1998, 1999, and 2000). By tripling the annual sample size of the CPS, this approach improves the statistical precision of NCCP's estimates of the impact of state EIC programs.

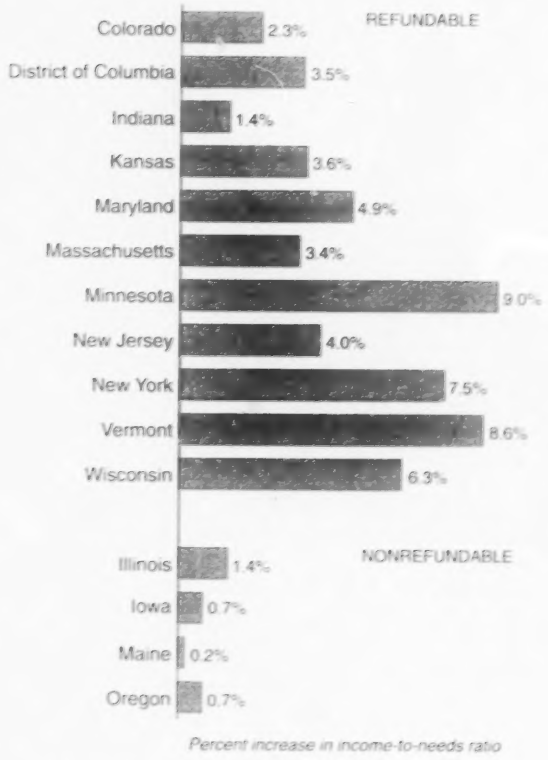
In addition, it is important to note that the official measure of poverty used by the federal government omits income derived from earned income credits, either federal or state. In contrast to the official measure, NCCP uses an alternative measure in this publication that is based on research conducted at the U.S. Census Bureau. This latter measure

Figure 2: State EICs: Percentage of federal credit in tax year 2000



Notes: (a) Residents of Indiana are eligible for the state EIC only if their income is less than $12,000. The EIC is computed as 3.4 percent of the difference between $12,000 and the family's earned income; (b) Individuals are allowed to opt for either a refundable or nonrefundable EIC, whichever is greater; (c) one child; (d) two children; and (e) three or more children.

Figure 3: Percentage increase in income-to-needs ratio towards the poverty line due to state EICs, for children under age 18 in families with at least one employed parent



Note: Rhode Island also has a nonrefundable EIC, but its precise impact cannot be determined from data in the March Current Population Survey.

incorporates many sources of income—most notably for this study, earned income credits—that the official measure does not. (See the Appendix for a more detailed discussion of poverty measurement issues.)

Earned Income Credits' Impact on State Income-to-Needs Ratios

NCCP measures the effectiveness of state EICs by assessing the improvement in the income-to-needs ratio of children in working poor families due exclusively to these state programs. The income-to-needs ratio is defined as the family's income divided by the poverty threshold associated with that family's size and structure. For example, if a family had an income of $12,000 and the poverty threshold for this family were $16,000, then its income-to-needs ratio would be 75 percent.

As seen in Figure 3, the EIC moved the income-to-needs ratio for children in working poor families (i.e., in families in which at least one parent is employed) in Maine (a state with a nonrefundable EIC) only 0.2 percent of the distance towards the poverty line.[11] In Illinois, Iowa, and Oregon, the other three states that had exclusively nonrefundable state EIC programs, the income-to-needs ratio also barely rises in response to their respective programs. In the last two states, the ratio moves only 0.7 percent towards the poverty line due to the state credit, and in Illinois, by only 1.4 percent. At the other extreme, incomes rose by 9.0 percent towards the line in Minnesota and by 8.6 percent in Vermont as a result of their state EICs. The refundable EICs in 9 states and the District of Columbia have considerably greater positive impact on the economic well-being of children in working poor families than the nonrefundable credits in Illinois, Iowa, Maine, and Oregon.[12]

Figure 4: Number of children under age 18 with at least one employed parent (in 1,000s) potentially lifted out of poverty due to state EICs in 12 largest states, pegged at 50 percent of the federal credit

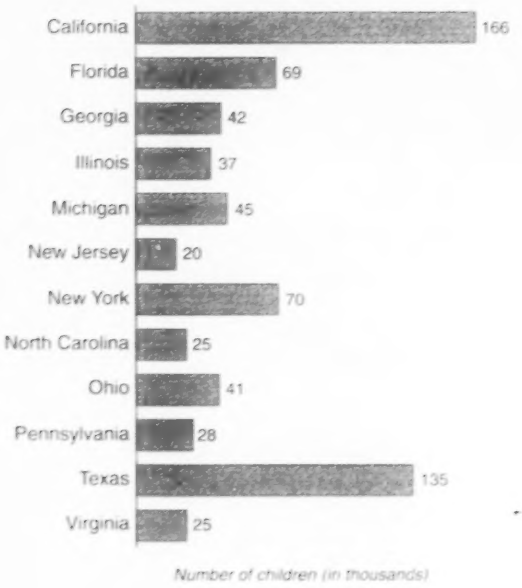
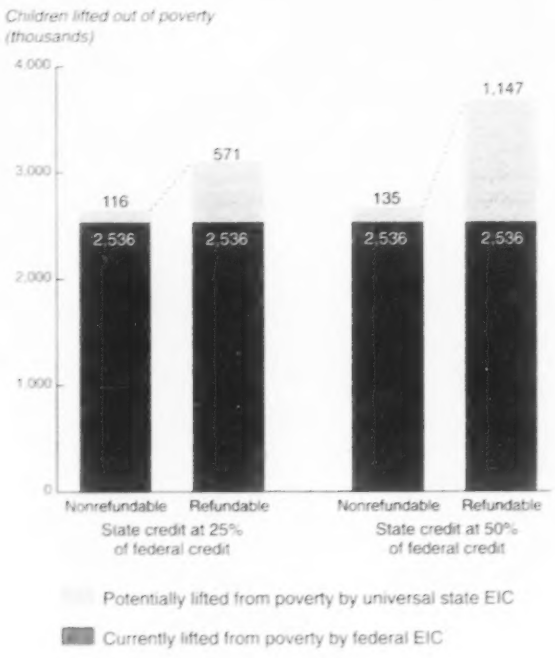


Figure 5: Number of children under age 18 with at least one employed parent (in 1,000s) potentially lifted out of poverty by state EICs



Estimates of Children Lifted Out of Poverty Given Universal State EICs

Suppose that all 50 states and the District of Columbia enacted state EIC programs that provided refundable credits amounting to 25 percent or 50 percent of the federal credit. The income-to-needs ratio of children in working poor families would increase considerably under these hypothetical scenarios. Specifically, the income-to-needs ratio for the United States as a whole would move about 9 percent of the way towards the poverty line given a universal 25 percent state EIC. A 50 percent state EIC would push the income-to-needs ratio twice as far, or 18 percent of the distance towards the poverty line.

Figure 4 displays the number of children with at least one employed parent who would be raised out of poverty in the 12 states whose population of children under age 18 exceeded 1.5 million.[13] Approximately one-half of all children nationwide who would escape poverty as a result of a universal refundable state EIC reside in these 12 states. California is the home of a disproportionately large number of children in poverty—one in six poor children in America lives there— and a state EIC program would benefit many more children there than elsewhere. In California, 92,000 children would be lifted from poverty by a 25 percent state EIC and about 166,000 from a 50 percent state EIC. Large numbers of poor children in Texas, too, would escape poverty due to a state EIC program: 62,000 at the 25 percent level and 135,000 at the 50 percent level.

Figure 5 shows the potential impact of state EIC programs for the nation as a whole in terms of numbers of children lifted out of poverty. Under a universal 25 percent refundable state EIC, the families of approximately 570,000 children would rise out of poverty. Under a universal 50 percent refundable state EIC, the families of over 1.1 million children would be lifted from poverty.[14]

In contrast, only 116,000 children would be raised out of poverty if the universal state EIC programs were nonrefundable at the 25 percent level, rather than refundable. That figure rises modestly to 135,000 if the nonrefundable credit is pegged at 50 percent of the federal credit. Thus, at the 50 percent level, more than eight times as many children are lifted out of poverty as a result of universal refundable, rather than nonrefundable, programs.

In a universal nonrefundable program, by definition, the amount of credit is limited to the family's state income tax liability and no more. The most generous nonrefundable state EIC programs, then, would reduce all eligible individuals' state income tax liability to zero. Under such a scenario, the maximum number of children who could be lifted out of poverty would be only approximately 220,000. A universal 50 percent refundable state EIC program would lift five times as many children out of poverty as the most generous nonrefundable program.

Conclusion

This research brief applies an alternative measure of poverty devised by the U.S. Census Bureau to document the benefits to children in working poor families due to EIC programs in the District of Columbia and the 15 states that had such programs in place in 2000. The impact of such programs varied, in large part as a result of whether the credit was refundable or nonrefundable and also as a result of the percentage of the federal EIC at which each program was pegged.

Furthermore, this brief answers the following question: What would be the effect on child poverty if a 25 percent or 50 percent refundable state EIC existed universally among the states? Improvements in the income-to-needs ratio would amount to 9 percent and 18 percent, respectively, due to these universal programs. Perhaps the most important conclusion is that if sizable state EIC programs existed among all the states, then substantial numbers of children would no longer be poor. With a 25 percent universal state EIC, over 500,000 children would escape poverty; with the more generous 50 percent universal state EIC, the figure rises to above one million.

These findings illustrate the significant potential of state EIC programs to reduce child poverty in the United States—but only if the credit is refundable and set at a sizable percentage of the federal credit. A nonrefundable credit would lift very few children out of poverty compared to a refundable credit.

The potential benefit of expanded state EIC programs to working poor families is clear. It is worthwhile to note how states can finance such programs. One option is for a state to finance the EIC from its general fund. However, in recent years it has been possible to fund the refundable portion of the credit from the Temporary Assistance to Needy Families (TANF) block grant created by the 1996 federal welfare law. States are likely to consider whether to use general funds or block-grant funds to finance the credit based on several factors, including their fiscal situation and budget priorities, and the amount of unallocated TANF funds or "maintenance of effort" funds available to them.[15]

Based on their current and potential impact on family income—and the evidence of the positive effects of fiscal incentives that reward work on both family economic security and child development—state EICs hold considerable promise to improve the lives of working poor parents and their children.

Appendix: Defining Poverty

The official poverty measure, developed by the federal government in the early 1960s, has been challenged by the National Academy of Sciences' (NAS) Panel on Poverty and Family Assistance,[16] among many others, because of a concern that the official measure of poverty does not reflect changes in policies and programs that affect individual or family economic well-being. Examples include policies such as food stamps and the earned income credit.[17] The NAS Panel also noted that the official measure does not adequately address family structure; changes in the standard of living since the 1960s; geographical differences in the cost of living, including housing expenses; as well as many critical family expenditures, such as those related to medical care, child care, and work.

Recently, the U.S. Census Bureau released a series of "experimental" measures, which, to varying degrees, correct for some of the deficiencies in the current measure.[18] To date, however, the official measure remains in place. In this research brief, NCCP relies on an amended version of a measure developed by the U.S. Census Bureau—termed "DES-DCM2." The Census Bureau measure—the most comprehensive of the experimental measures they devised—incorporates the factors mentioned previously that have been omitted from the official measure. The poverty thresholds used in this report were adjusted for the 1998 consumption pattern, geographical differences in the cost of living, and family structure. The measure NCCP adopts in this brief is essentially the Bureau's experimental measure, but with the important inclusion of any income derived from state earned income credits. NCCP assesses the impact of state credit on child poverty by comparing the result from the measure that incorporates those credits with the result from the measure that does not.

Endnotes

1. Bennett, N. G.; Li, J.; Song, Y.; & Yang, K. (1999). *Young children in poverty: A statistical update.* New York, NY: National Center for Children in Poverty, Columbia University, Mailman School of Public Health.

2. Johnson, N. (2000). *How much would a state earned income credit cost?* Washington, DC: Center on Budget and Policy Priorities.

3. As noted above, several states have no state income tax. The authors still posit the existence of EIC programs in these states, however, because a state EIC could be provided as a rebate to help offset other state taxes on working poor families, such as sales taxes.

4. Bos, H.; Huston, A.; Granger, R.; Duncan, G.; Brock, T.; & McLoyd, V. (1999). *New hope for people with low incomes: Two-year results of a program to reduce poverty and reform welfare.* New York, NY: MDRC.

5. Auspos, P.; Miller, C.; & Hunter, J. A. (2000). *Final report on the implementation and impacts of the Minnesota Family Investment Program in Ramsey County.* New York, NY: MDRC.

6. See, for example, Bennett, Li, Song, & Yang in endnote 1, and Council of Economic Advisers. (1998). *Good news for low-income families: Expansions in the earned income tax credit and the minimum wage.* Washington, DC: Council of Economic Advisers.

7. Johnson, N. (2000). *A hand up: How state earned income tax credits help working families escape poverty, 2000 edition.* Washington, DC: Center on Budget and Policy Priorities.

8. Meyer, B. D. & Rosenbaum, D. T. (2000). Making single mothers work: Recent tax and welfare policy and its effects. In D. Holtz-Eakin & B. D. Meyer, (Eds.). Special journal issue: The earned income tax credit. *National Tax Journal,* 53(4, part 2), pp. 1027–1061; Ellwood, D. T. (1999). The impact of the earned income tax credit and social policy reforms on work, marriage, and living arrangements. In D. Holtz-Eakin & B. D. Meyer, (Eds.). Special journal issue: The earned income tax credit. *National Tax Journal,* 53(4, part 2), pp. 1063–1105; and Eissa, N. & Liebman, J. B. (1996). Labor supply response to the earned income tax credit. *Quarterly Journal of Economics,* 112(2), pp. 605–637.

9. Dickert, S.; Hauser, S.; & Scholz, J. K. (1995). The earned income tax credit and transfer programs: A study of labor market and program participation. In J. M. Poterba, (Ed.). *Tax policy and the economy, vol. 9.* Cambridge, MA: MIT Press.

10. Note that residents of Indiana are eligible for the state EIC only if their earned income is less than $12,000. The EIC is computed as 3.4 percent of the difference between $12,000 and the taxpayer's adjusted gross income.

11. This statistic is calculated as 100 x {[income-to-needs ratio with state EIC] – [income-to-needs ratio without state EIC]} / {1 – income-to-needs ratio without state EIC}.

12. Given the nature of the income data in the CPS for the state of Rhode Island, NCCP could not assess the effectiveness of that state's EIC. Rhode Island's EIC is incorporated implicitly in its state tax. Thus, using CPS data, one cannot sort out Rhode Island's nonrefundable credit from the remainder of the state tax.

13. We focus on these 12 largest states in order to maximize the statistical reliability of our estimates.

14. Note that the number of children lifted out of poverty due to the federal EIC program is based on comparing poor children using income figures that include the federal EIC with those that do not. In contrast, the number of children raised out of poverty due to state EIC programs uses as its base for comparison income that already includes the federal EIC.

15. See Johnson in endnote 7.

16. Citro, C. F. & Michael, R. T., (Eds.). (1995). *Measuring poverty: A new approach.* Washington, DC: National Academy Press.

17. In the official poverty measure, the federal government includes the following income sources: wages and salary, nonfarm self-employment, farm self-employment, AFDC/TANF and General Assistance, Social Security, Supplemental Security Income, unemployment compensation, worker's compensation, veteran's payments, interest, dividends, rents, survivor's income, disability, retirement income, child support, education benefits, financial assistance payments, and other sources.

18. Short, K.; Garner, T.; Johnson, D.; & Doyle, P. (1999). *Experimental poverty measures: 1990 to 1997* (Current Population Reports, Consumer Income Series, No. P60-205). Washington, DC: U.S. Census Bureau, and Short, K.; Iceland, J.; & Garner, T. I. (1999). Experimental poverty measures: 1998. <http://www.census.gov/hhes/poverty/povmeas/exppov/exppov.html>

National Center for Children in Poverty
Mailman School of Public Health
Columbia University
154 Haven Avenue
New York, NY 10032
TEL (212) 304-7100
FAX (212) 544-4200 OR
(212) 544-4201
www.nccp.org

National Center for Children in Poverty (NCCP) was established in 1989 at the School of Public Health, Columbia University, with core support from the Ford Foundation and the Carnegie Corporation of New York. The Center's mission is to identify and promote strategies that prevent child poverty in the United States and that improve the lives of low-income children and their families.

Childhood Poverty Research Briefs

This research brief series presents timely research findings on the nature, scope, and impact of child poverty in the United States, primarily based on analyses by researchers at or affiliated with the National Center for Children in Poverty. The series explores the causes and consequences of child poverty and also identifies and critically examines promising strategies to reduce the incidence of child poverty. As with much of NCCP's work, there is a strong state and local focus. NCCP appreciates the generous support of the Annie E. Casey Foundation that made this research brief possible.

Untapped Potential: State Earned Income Credits and Child Poverty Reduction

by Neil G. Bennett, Senior Advisor to NCCP for Demographic Research and Analysis and Professor of Public Affairs, School of Public Affairs, Baruch College and Graduate Center–City University of New York, and Hsien Hen Lu, Assistant Professor of Public Health, Mailman School of Public Health at Columbia University. The authors thank Nick Johnson, Kathy Short, and Sheldon Danziger for their helpful comments and suggestions concerning this research brief.

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